

Taking a tactical view

In volatile conditions, investors can benefit from taking tactical views on fast changing capital markets. Steve Cleal, head of asset allocation fund management for Aviva Investors, explains how global tactical asset allocation portfolios are managed for pension schemes.

Aviva Investors global tactical asset allocation (TAA) team devotes a lot of resources to analysing the global economy for a very good reason. In order to predict where asset prices are going, it is important to have a sound grasp of cyclical trends i.e. likely movements in economic growth, interest rates, inflation etc... For instance, during recessions, profits tend to fall and equities perform poorly as investors de-risk portfolios. Government bond markets tend to benefit from these trends as investors search for safer havens. This type of analysis enables us to position TAA portfolios appropriately given the economic outlook.

A critical element in our process is to spend time looking at all the possible outcomes. We are very aware that we are not going to be right 100% of the time so we need to know what might happen if our central forecasts do not pan out as expected. For instance, early last year we identified downside risks to the global economy and assigned a modest probability to a deep recession in western economies. Against this backdrop, a number of defensive positions were adopted which would add value if economic growth disappointed. Funds had a short exposure to equity markets and were positioned to benefit from reductions in short interest rates in Europe and the UK.

Last year in focus

Early in 2008, our central (most likely) scenario was for a slowdown but most of the risks were skewed to the downside. This view reflected the limited availability of credit and high levels of indebtedness. As the year developed, the probability attached to the recessionary scenario was raised with clear implications for asset selection. The important point to note is not that we had perfect foresight, but that we identified the economic risks and built a robust portfolio that could weather the storm. Assets were selected so that if economies did enter recession, our portfolio would still add value.

Successful absolute return strategies should be able to generate positive returns in all market conditions. By adopting short positions, asset values can be protected during declining markets. In contrast, standard equity funds may outperform the index in a bear market, but investors are still likely to lose money.

Tactical investing

TAA strategies often seek to take positions in assets which have been driven away from fair

Credit crisis: milestones since July 2007 - Yield on corporate bonds over gilts



Source: BarCapSONGOS as at 8 January 2009

value by swings in sentiment and periods of high volatility should throw up numerous opportunities to add value. Access to liquid derivatives markets makes it possible to take advantage of these opportunities quickly and cost effectively. When assessing value, it is important to take the position in the economic cycle into account. For instance, equities currently look attractive on most normal criteria. But once the economic risks have been taken into account, the next six to nine month outlook becomes less clear. When the economy improves and risks recede, however, dividend and earnings yields need not be as high relative to bond yields to make equities appear attractive.

The stance today

Despite the risks, we have recently adopted a small tactical long position in equities. Global economies are in for a further period of weakness but because stockmarkets have fallen so rapidly, and sentiment is so depressed, we think there is an opportunity for a short-term bounce. Even during bear markets, equities still have the capacity to rally sharply from time to time. We are also long corporate bonds. Defaults will rise sharply over the next twelve months but they are unlikely to reach the levels implied by current yield spreads. This makes credit an attractive asset class.

Uncertainties relating to how western economies will develop over the next six months mean that it is not appropriate to take any single large position. Rather, risk is spread across a range of different asset classes, including currencies. These positions are well diversified and when combined, should be able to produce attractive returns across a range of different outcomes.



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